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SUBJECT: Macroeconomic Developments in Vietnam

REF: HANOI 1149

¶1. (SBU) Summary. With capital inflows, inflation and credit growth reaccelerating, the State Bank of Vietnam (SBV) is under increasing pressure to reign in liquidity. Because of official policies calling for stable interest rates and exchange rates, however, SBV has been forced to resort to blunt instruments such as reserve requirements as the main tools to deal with these challenges. Even open market operations were halted for a time due to conflicts between the Ministry of Finance (MOF) and SBV. Nevertheless, authorities and market participants remain confident that the favorable growth environment will continue in the short and medium term. End Summary.

¶2. (U) This is one of five cables reporting on the visit of Regional Financial Attache Susan Baker's May 29-June 1 visit to Vietnam. This message reports her findings and impressions of recent macroeconomic developments.

INFLATION PICKING UP

¶3. (SBU) The SBV acknowledges that inflation in the first half of 2007 will likely surpass 2006 levels and blames this development on the impact of WTO accession, the subsequent loss of the ability to control administered prices and new increases in fuel prices. The SBV official in charge of foreign exchange policy also noted that Vietnam's progressive liberalization of the capital account has increased capital inflows, leading to monetary expansion. The same official cited first quarter 2007 foreign inflows of $2.5 billion in FDI and $1 billion in remittances and first half 2007 portfolio inflows of $3.4 billion.

¶4. (SBU) SBV officials also blame the MOF's expansive fiscal policy, particularly the government's policy of large increases in civil service wages, for fueling inflationary expectations. Following an increase of 28.5 percent in October 2006, the SBV was able to win a concession from the MOF for no civil servant salary increases in
¶2007. In a separate meeting, MOF officials defended their policies and reiterated their view that such large increases are needed as part of the GVN's civil service reform efforts aimed at reducing corruption, and they expect the increases to resume in the future.

CREDIT GROWTH

¶5. (SBU) The SBV's monetary policy officials are also concerned about a resurgence of credit growth. One official source reported that while credit growth had fallen from its 2004 peak of around 40 percent to around 20 percent in the second quarter of 2006, it has moved back up into the 30 percent annual growth range more recently.
(Note: SBV's banking policy and supervision officials were not

particularly concerned about the rising credit growth, which they said was needed to support high GDP growth and could be controlled with risk management and provisioning policies. End note.)

DRAMATIC INCREASE IN RESERVE REQUIREMENTS

¶6. (SBU) The SBV noted that the SBV Governor has approved essentially to double the minimum reserve requirements effective on June 1, 2007. The SBV officers expect the (unremunerated) reserve requirement for Vietnamese Dong-denominated deposits will increase from 4 percent to 8 percent, while U.S. dollar-denominated deposits will increase from 8 percent to 10 percent, although they said exact rates will also depend on the term of the deposits. Bankers later reported that they had heard reserve requirements will rise from 5 percent to 10 percent.

¶7. (SBU) Surprisingly, market participants said the very large reserve requirement change has had no impact on the interbank lending market -- at least up to the first day of official implementation. The SBV, the IMF resident representative and some market participants noted that most banks already had been holding excess reserves at the SBV before the increase, so they might not need to borrow more funds to meet the new requirement.

MONETARY INSTRUMENTS GOING UNUSED

¶8. (SBU) When asked what else could be done to tighten monetary policy, SBV officials dismiss the options of raising interest rates or allowing the currency to appreciate, noting the government's policy objective of keeping these two items stable. Regarding the exchange rate, one SBV official explained that letting the currency appreciate would be hard on exporters. He also cited China as an

example of a fast-growing economy with strong capital inflows that has not let its currency appreciate. SBV officials did say that they will be able to increase open market operations by issuing more SBV bills, although they consider it a relatively limited tool for addressing inflation due to the long lag time for such operations to have an effect. (Note: According to one official source, the MOF chastised the SBV for issuing too many SBV bills and crowding out MOF fundraising efforts. This led to a temporary halt on SBV issuances that may have contributed to the high liquidity environment.)

¶9. (SBU) Comment: The muted impact of such a large increase in reserve requirements is disconcerting, considering the Vietnamese unwillingness to use other instruments to reign in liquidity. The disputes between the SBV and the MOF, as well as the differing views of the SBV's monetary and banking supervision divisions, make it clear that not everyone is on board with the need to reign in excess liquidity in the economy. With credit growth reaccelerating, especially at the private banks, and limited risk management systems, continued inaction may be storing up problems for when the economy slows down. End Comment.

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